Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:NEW:TL-N-6244-00
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to: Ann Lyons
Team Manager

from: Area Counsel LMSB Financial Services and Health Care
Newark, New Jersey

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subject: [redacted]
Increase in Reserves Attributable to Reduced Surrender Charges
[redacted]

This is in response to your request for my opinion as to whether the taxpayer is entitled to increase its life insurance reserves for "benefit enhancements" on certain annuity contracts arising from a Board of Director's resolution. I agree that the reserve increase deducted by the taxpayer in your case is not allowable. The analysis set forth below is proposed as a supplement to the position taken in your report.

The facts as we understand them are as follows:

The taxpayer issues flexible premium retirement annuity contracts, deposit administration group annuity contracts, and group deposit fund contracts. These contracts are accumulation annuity policies qualifying as "life insurance policies" under I.R.C. § 807 in that they contain annuitization options with permanent purchase guarantees. Pursuant to I.R.C. § 807(d)(3), the taxpayer uses the CARVM method in computing reserves for such policies. The contracts provide that if the policies are surrendered, the policyholder receives the surrender value, which is the cash value subject to surrender charges. Surrender charges are shown as the cash value times a "surrender factor." Under this formula (which varies from contract to contract in respects not relevant here), the policyholder receives a percentage of his cash value, depending on the policy year, for the first ten years of the policy's life. The surrender factor declines over the ten year period, and reaches zero (full surrender value) in year 11.

The policies also provide that the written contract is the entire contract, and cannot be changed unless such change is approved in writing by certain principals of the company. The Deposit Administration contracts further state that "the terms and conditions of this contract may be amended or modified at any time or times by written agreement between the Company and the Contractholder and evidenced by written endorsement thereon or written amendment hereto."

On [redacted], the Board of Directors of the taxpayer approved a resolution effective [redacted] dictating that for policies surrendered on the last day of any policy year, the surrender factor applicable on the above-mentioned policies shall be the factor shown in the table for the subsequent policy year.

The taxpayer states the following as to this change: "This feature is an enhancement in the benefits provided to our policyholders allowing them to receive a reduced surrender charge earlier than was previously available....The benefit enhancement was approved by the Board of Directors and is currently used in the calculation of policyholder benefits but there was no general announcement to the policyholders." The taxpayer has not otherwise explained the purpose for this resolution.

The taxpayer increased its annuity reserves by $[redacted]. It claims that this was not a change subject to section 807(f) because it was not a change in the method of computing its reserves. It alleges that before and after the resolution, it computed its CARVM reserves by taking into account "future guaranteed benefits, including guaranteed nonforfeiture benefits, provided for by such contract at the end of each respective contract year" as required by the Standard Valuation Law. Because CARVM reserves calculate present values based on benefits as of the end of each policy year, it computed its reserves on the assumption that policyholders would terminate the policies on the last day of the policy year. Further, because the change is due to a change in the underlying features of the product, it is a 'change in fact' and not a change in method.

The taxpayer did not submit the change in surrender charges to any state insurance departments for approval, did not attach a surrender charge rider to any existing contracts, and did not forward notice of the change in surrender charges to policyholders.

The taxpayer states that its statutory reserves were not affected by the benefit resolution. It did not modify its premium structure to take into account the "benefit enhancement."

Analysis

The taxpayer argues that it is entitled to increase its life insurance reserves to take into account a decrease in surrender charges effective for policyholders terminating on the last day of the policy year, pursuant to a Board of Directors resolution declaring this change in benefits.

I.R.C. § 807(b) provides a deduction for increases in reserves, including life insurance reserves. I.R.C. §§ 807(d)(2)(A) and 807(d)(3)(A)(ii) dictate that the proper reserve method applicable to annuity contracts is the CARVM method. As the taxpayer notes, in Technical Advice Memorandum 9452001, we ruled that the CARVM method required the taxpayer to consider the guaranteed accumulation values at the end of each future contract year, including withdrawal values during a "one day window" at the end of the policy year when surrender charges were not imposed. The provisions under consideration were included in the policies as issued. Thus, had the taxpayer issued policies which provided the policy provisions in question, we would not dispute that the CARVM reserves must take such year end surrender charge provisions into account.

In the instant case, the benefit provisions were imposed pursuant to a Board of Director's resolution issued subsequent to the year of issue. The taxpayer argues that this resulted in a contract modification that required an increase in reserves to be taken into account in valuing reserves for the year of modification. As discussed below, I do not agree that the Board of Director's resolution resulted in a contract modification. However, even assuming the effect of this resolution is a contract modification, I do not agree that the taxpayer would be allowed to increase its reserves. The taxpayer states that in the case of [redacted]'s contracts, as is typical of recently issued deferred annuity contracts, there are no contractually required future premiums. No premium modifications were imposed as a result of this resolution. Therefore, this "benefit enhancement," as the taxpayer describes it, was not reflected in the premium charges made under the contract.

I.R.C. § 811(c)(1) prohibits a reserve from being established for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in life insurance gross income. Thus, assuming the resolution resulted in a contract modification, a reserve is not allowable for this "benefit enhancement" because the taxpayer did not take premiums into account for this item.

In my opinion the Board of Director's resolution is properly characterized as a policyholder dividend rather than as a contract modification. The term "policyholder dividend" includes increases in benefits otherwise qualifying as a dividend. I.R.C. § 808(b)(1). A deduction for policyholder dividends is allowable to the extent such dividends are "paid or accrued." I.R.C. § 808(c)(1). As explained below, under accrual accounting principles, the taxpayer's liability for the "benefit enhancement" does not accrue unless and until the policyholder elects to terminate his policy on the last day of the policy year.

Section 808(e) provides that a policyholder dividend which increases the cash surrender value or other benefits payable under the contract is treated as paid to the policyholder and returned by the policyholder to the company as a premium. This is to allow a reserve deduction to be credited for such benefits where there has been no actual premiums paid. [1] However, because the policyholder dividends at issue have not been paid or accrued, as required by section 808(c)(1), section 808(e) does not apply.

I.R.C. § 808(a) defines policyholder dividends as any dividend or similar distribution to policyholders in their capacity as such. Section 808(b) provides that, for purposes of Subchapter L, the term "policyholder dividend" includes--

(1) any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the

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[1]Section 808 in this and other respects codifies a position previously found in Revenue Ruling 82-133, 1982-2 C.B. 119, in which the Service ruled that excess interest on deferred annuities which was not guaranteed beyond the policy year was a policyholder dividend. It further held, citing the legislative history of the 1959 Life Insurance Act, that once it is determined that excess interest is a dividend to policyholders, deductible additions to reserves for such interest can arise only if such dividends are viewed as deemed payments returned by the policyholder to the company as premium income. The industry strongly objected to this ruling. Congress cited Revenue Ruling 82-133 and the industry's contrary position in the legislative history to the 1982 TEFRA amendments, and referred to the dispute over excess interest in the legislative history to section 808. Senate Comm. on Finance, <u>Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21</u>, 1984, Vol. I, S. Report No. 98-169, 98th Cong., 1st Sess. 547 (1984); S. Rep. No. 97-494, 97th Cong. 2nd Sess. 346; H.R. Rep. No. 97-760, 97th Cong., 2nd Sess. 646; <u>See</u> <u>also</u>, Staff of Joint Committee on Taxation, 97th Cong., 2d Sess., <u>General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982</u> 359 (Comm. Print. 1983).

contract but depends on the experience of the Company or the discretion of the management.

In Modern American Life Insurance Co. v. Commissioner, 92 T.C. 1230 (1989), the taxpayer issued a Board of Director's resolution 'guaranteeing' an additional benefit. The issue was whether the resolution resulted in an 'accrued benefit' or a policyholder dividend. The Court applied Treas. Reg. § 1.811-2(a), which contains the language now found in section 808(b)(1). The Court held that a benefit 'fixed in the contract" was a benefit that was bargained for by the policyholder, which is the case where the cost to the insured is based upon the benefits that the insured chooses to buy. Conversely, amounts paid as dividends are determined unilaterally by the insurance company. The court concluded that the benefits at issue were not 'fixed in the contract' because the policyholder's entitlement to the benefits was not contained in the four corners of the instrument and there were no riders, endorsements or supplemental contracts signed by the insurance company and the insured relating to the benefit. 92 T.C. at 1243-44. The Court also noted that the amount of the benefit depended solely on the discretion of management, as it was determined unilaterally. 92 T.C. at 1247.

A key factor relied upon the court for the conclusion that the benefits qualified as a policyholder dividend was the lack of notification to policyholders. The Court observed:

> The element of secrecy concerning the increased benefits strongly implies an intent by management to maintain discretion and flexibility concerning payment in subsequent years, rather than an intent to give policyholders an irrevocable right to legally enforce future payments. A policyholder was not explicitly told of the increased benefits until and unless she tried to cancel the policy in the mistaken belief it was not competitive with another insurer. Otherwise, she merely continued to receive a single yearly check, similar to the dividend check received in prior years. ... Our position is further supported by the fact that petitioners never actually amended the affected policies to include the "guaranteed" benefits, *a process required by the terms of the contract in order to modify the contract.* No rider or endorsement was ever sent to policyholders, despite NAIC's explicit recommendation.

92 T.C. at 247. See also, Technical Advice Memorandum 9130009.

Since the taxpayer unilaterally determined to provide the benefit at issue, never notified the policyholders, did not attach riders to its policies, or notify the state of its proposed benefit changes, the Board of Director's resolution is a policyholder dividend and not a contract modification.

The taxpayer maintains that state insurance departments would not permit the passing of another resolution rescinding the enhancements, and that therefore, the enhancement should legally considered to be permanent. However, it also maintains that it was not required to notify the state of the "benefits enhancement." A similar argument was made in Modern American, supra, where the taxpayer introduced testimony to the effect that the state would have enforced a policyholder's claim for such benefits. The Court rejected that argument, noting that it was entirely speculative whether, in light of the secrecy attendant upon the provision, policyholders would ever be notified of the provision, file claims, have their claims rejected, and whether, if so, the state would enforce such claims. 92 T.C. at 247. Similarly, whether state insurance departments would intervene to preclude a revocation of the Board of Director's resolution that neither policyholders nor the insurance regulators were never informed of is entirely speculative.

The taxpayer may argue that the "benefit enhancement" cannot qualify as a policyholder dividend because the policies are not participating. However, in Revenue Ruling 82-133, 1982-2 C.B. 119, the Service ruled that a participating contract was a contract which provided a policyholder benefit as defined in Treas. Reg. § 1.811-2, which determination was not dependent on the labeling employed.

Life insurance companies calculate the deduction for policyholder dividends in accordance with accrual accounting principles. I.R.C. § 808(c)(1); National Life Insurance Co. v. Commissioner, 96 F.3rd 639 (2d Cir. 1996). Under accrual accounting principles, the taxpayer's liability for the "benefit enhancement" does not accrue unless the policyholder elects to terminate his policy on the last day of the policy year.

I.R.C. § 461(a) provides that the amount of any allowable deduction or credit shall be taken into account in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Treas. Reg. § 1.461-1(a)(2) provides that, for taxpayers using an accrual method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Although expenses may be deductible before they have become due and payable, the all events test requires that liability must first be firmly established. United States v. General Dynamics Corp., 481 U.S. 239, 243 (1987). A taxpayer may not deduct a liability that is contingent. Lucas v. American Code Co., 280 U.S. 445, 452 (1930). Thus, if the obligation to make a payment does not become binding until the occurrence of events that have not occurred by the close of the taxable year, then it ~~is~~ contingent and not deductible until those events occur. General Dynamics, 481 U.S. at 243-244. Since the liability for the increased surrender values is contingent on the policyholder's terminating the policy on the last day of the policy year, it does not satisfy the all-events test prior to such termination.

Moreover, the taxpayer has not demonstrated that it can make a reasonably accurate estimate of the amount of the policyholder dividend. This would require an accurate estimate of the number of policyholders likely to terminate on the last day of the policy year without knowledge of the benefit change implemented by the Board of Director's resolution. Assuming such an estimate could be made, it is not the amount deducted by the taxpayer. Rather, the taxpayer applied the CARVM assumption that all policyholders would terminate on the last day, which is clearly not a reasonably accurate estimate.

Although I agree with your conclusion that the Board of Director's resolution is tax-motivated, that conclusion is not the basis for the above analysis. The above analysis assumes that the resolution was fully binding and effective for the year of declaration, as would be the case for any Board of Director's resolution declaring a dividend. However, because the resolution by its terms created a liability that was subject to a contingency, it is not an accrued liability for purposes of section 808(c)(1).

This conclusion is consistent with Congressional intent. Prior to 1984, companies were allowed to use the reserve method of deducting for policyholder dividends, in accord with statutory accounting. See, former I.R.C. §811(b). In 1984 Congress enacted section 808, which required companies to change from the reserve to the accrual method. In doing so, Congress assumed most companies' general business practice was to declare policy dividends at the end of the calendar year to be payable on policy anniversaries during the following calendar year only in the event the policy remained outstanding on such anniversary. Such declarations were fully "binding" on insurance companies by their terms. However, because the payment of such dividends were subject to a contingency, Congress further assumed that given these general business practices, the 1984 change in policyholder dividends accounting had the effect of delaying the deduction for policyholder dividends to the taxable year in which they are paid. S. Rep. No. 99-313, 99th Cong., 2d Sess. 965 (1986); National Life Insurance Co. v. Commissioner, 103 T.C. 615, 631 (1994), aff'd., 96 F.3rd 639 (2d Cir. 1996). Thus, Congress assumed that a liability for policyholder dividends contingent on the policyholder's taking a particular action would not satisfy the all-events test prior to the occurrence of that action.

Because the policyholder dividend declared by the Board of Directors in your case did not accrue in [redacted], it is not deductible under section 808(c)(1). As a result, section 808(e) does not apply and the taxpayer is barred by section 811(c)(1) from increasing reserves for the benefits created by this declaration.

Please call me at (973) 645-2572 if you have any questions.

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